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Pension World

The Magazine for Plan Sponsors and Investment Managers/ A Publication of Communication Channels, Inc.

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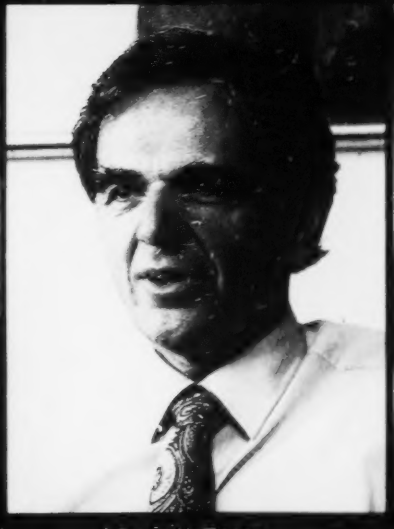

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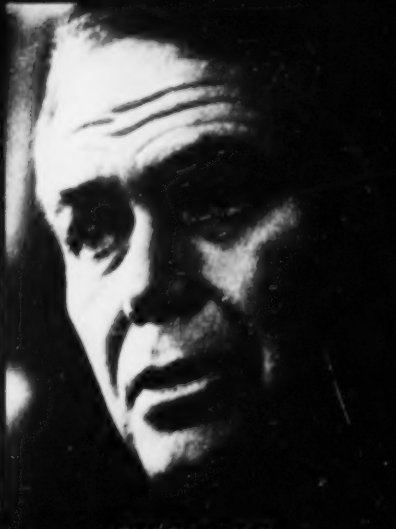

Bob Packwood

What Will Congress Do Next?
9th Annual ERISA Compliance Calendar

Pension World

January 1985
Volume 21 Number 1

The Magazine for Plan Sponsors and Investment Managers/A Publication of Communication Channels, Inc.

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BPA

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Top corporations support 401(k) plans

Companies are racing to set up salary reduction plans, according to a survey of the Fortune 200.

Tax-deferred salary reduction plans, also called 401(k) plans, were authorized by the Internal Revenue Service in late 1981. They have received a warm reception in many organizations around the country. Several surveys of these salary reduction savings and profit-sharing plans have been conducted by employee benefit consulting firms. Towers, Perrin, Forster and Crosby, Buck Consultants, Hewitt Associates, the Wyatt Company, and others have issued reports in the past year which give valuable information about the characteristics, participation rates, and employer experiences with these new retirement-oriented capital accumulation instruments.

There are, of course, many reasons why 401(k) options have become important. The plans offer employees several attractive benefits:

1. Contributions reduce taxable income immediately;
2. Contributions can be placed in one or more investment options;
3. Matching employer contributions are permitted for part of the employee contributions;
4. Lump sum distributions from these plans can be eligible for long-term capital gains treatment and ten-year forward averaging tax treatment, favorable options not available for funds placed in Individual Retirement Accounts.

Since their inception, 401(k) plans have become popular and the subject of continued interest and study. The purpose of this article is to provide knowledge about the plans which have been established by the largest United States corporations. It will present data on the actual dollar amounts contributed to these plans, the age mix of plan participants, and other information relating to the administration and implementation of these plans.

This information was obtained from a survey of the Directors of Employee Benefits of the Fortune 200 corporations conducted in August and September 1984. In all, 64 firms responded to the questionnaire. Of this number, 52 were willing to be listed as survey respondents, while 12 preferred not to be identified. Of the 64 respondents, 45 indicated that they had a 401(k) arrangement in place; 35 of these were savings plans and 10 were profit-sharing plans. Sixteen of the savings plans and five of the profit-sharing plans had been instituted in 1984. In addition, three of the respondents had both 401(k) savings and profit-sharing arrangements.

Other firms indicated that they were about to initiate 401(k) plans within their organizations. Twelve firms stated they had definite plans to initiate 401(k) savings arrangements between September 1, 1984 and August 1, 1985. Two responded they would begin 401(k) profit-sharing plans between December 1, 1984 and July 1, 1985. Thus, the majority of respondents either have or will soon institute tax-deferred capital accumulation plans for their employees. Of those that have no immediate plans for implementation, three stated that management had shown little interest despite several proposals emanating from benefits departments.

by **ALAN D. ENTINE**
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The respondents were asked to report the average monthly sums which employees and employers contributed to 401(k) savings and profit-sharing plans either in the period July 1, 1983 to June 30, 1984 or in the period the plan had been operating if it had been established after July 1, 1983. There were 37 responses to this query, representing 27 with savings plans and ten with profit-sharing plans. Tables 1 and 2 indicate the highest and lowest reported average monthly contributions and the average of contributions from all respondents.

These tables indicate that contributions to savings plans are likely to be higher than contributions to profit-sharing plans. Contributions to savings plans also appear to be more dependable that those which are related to a company's profits. In addition, the results show that current levels of contributions can build substantial retirement nest eggs. For example, assume that the average monthly contribution to 401(k) savings plan in Table 1 continues for 30 years ($167 plus $68 for twelve months, yielding $2820 per year for thirty years). Assume that these contributions are invested to produce an annual yield of ten percent. In 30 years these contributions would produce $463,873 which could then be received as a lump sum eligible for very favorable tax treatments. Clearly, 401(k) plans can produce significant retirement income to complement and even surpass Social Security income

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or pension income.

The survey next examined the age mix of 401(k) plan participants. Only a limited number of companies (nine) responded to this question in the survey. Benefits directors were asked to indicate the percent of eligible employees in various age groups who contributed to these plans in the period July 1, 1983 to June 30, 1984 or in the period the plan had been operating if it had been established after July 1, 1983. Table 3 reveals the results of this question.

While these data are limited, they do present the first look at age-related participation rates and indicate that middle-aged employees have the highest levels of interest in 401(k) plan opportunities. These findings are reinforced by other respondents who supplied age-related information in different formats. One reported that employees under age 40 had a 77 percent participation rate while those in the 40-65 age group participated at a rate which was double that of younger employees. Two others indicated that 41 percent and 56 percent of the participants in their plans were between 45 and 64 years of age. Two others stated that their participation rates were 95 percent and 99 percent across all age groups.

Most of this preliminary information indicates that middle-aged employees tend to participate extensively in 401(k) plans. Although income tends to be at high levels in the middle years, family expenses are also high. The critical factor may be that one thinks of retirement as a personal reality for the first time in middle age.

Table 1 401(k) Savings Plans, Average Monthly Contributions

	Employee Contributions	Employer Contributions
Company reporting highest average contribution	$320	$240
Company reporting lowest average contribution	$ 63	$ 16
Average of 27 companies	$168	—
Average of 24 companies*	—	$ 67

*Three companies had no employer contributions.

Table 2 401(k) Profit Sharing Plans, Average Monthly Contributions

	Employee Contributions	Employer Contributions
Company reporting highest average contribution	$190	$87
Company reporting lowest average contribution	$ 68	$35
Average of 8 companies	$125*	$52*

*Two companies indicated zero employee and employer contributions since there were no profits during the reporting period. The average above is based upon eight firms where profits existed.

Table 3 Percent of Eligible Employees in Each Age Group Who Contributed to 401(k) Savings and Profit Sharing Plans

	Under 25	Age 25 to 44	Age 45 to 64	Age 65 and over
Company A	66%	83%	93%	60%
Company B	63	85	92	83
Company C	20	40	65	50
Company D	13	18	45	50
Company E	10	33	62	25
Company F	NA	62	83	66
Company G	63	85	92	83
Company H	38	55	72	100
Company I	70	84	96	100
Average	43%	61%	78%	69%

NA = not applicable

Table 4 Percent of Salary Deferred to 401(k) Savings Plans

	Percent Deferred by Highest Paid One-Third	Percent Deferred by Lowest Paid Two-Thirds
Company reporting highest percentages	9.26	6.10
Company reporting lowest percentages	2.80	1.12
Average of 34 companies	4.90	3.04

Nondiscrimination

Employee contributions to 401(k) plans must meet nondiscrimination tests affecting the percent of salary deferred by the highest one-third eligible employees and the lowest two-thirds paid eligible employees. The response to a question about nondiscrimination ratios indicated there was a wide variability among these ratios in savings and profit-sharing arrangements. This is illustrated in Tables 4 and 5.

Profit-sharing plans appear to have a smaller spread between the percent of salary deferred by high- and low-paid groups than do savings plans. This may mean that it will be easier for profit-sharing plans to maintain compliance with 401(k) nondiscrimination participation tests.

Implementation

The survey requested information about the administration and implementation of these plans. Respondents were asked to identify and rank the means by which they informed employees about 401(k) plans. Communication tools which were the most useful received the lowest ranking (#1 for most useful, #2 for the next most useful, etc.). Table 6 indicates the number of responses and the average rank of those responses for each communications tool.

In addition, respondents indicated other tools were used, including individual enrollment letters when an employee became eligible to join a plan, an employee benefit telephone hotline, use of in-house video communications systems, use of employee bulletin boards, and annual enrollment sessions with

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Table 5 Percent of Salary Deferred to 401(k) Profit Sharing Plans

	Percent Deferred by Highest Paid One-Third	Percent Deferred by Lowest Paid Two-Thirds
Company reporting highest percentages	7.59	6.16
Company reporting lowest percentages	2.05	1.27
Average of 8 companies	5.08	3.63

Table 6 Communications Tools Used to Distribute Information about 401(k) Plans to Employees

Tool	Number of Responses	Average Rank of Responses
Special company publications	43	1.9
Information at employee orientation sessions	45	2.3
Company newsletters & memoranda	40	2.7
Seminars and workshops	31	3.0
Publications prepared by outside consultants	20	3.2
Individual employee counseling sessions	23	3.5

Table 7 How Employee Benefits Personnel Keep on Top of Changes in Federal Laws and Regulations Affecting 401(k) Plans

Means	Number of Responses	Average Rank of Responses
Subscription to specialized news services and publications	63	1.7
Outside consultants	58	2.2
Inhouse consultants	52	2.7
Attendance at seminars, workshops and conferences	60	3.6
Contacts with colleagues at other businesses & organizations	50	4.2
Newspaper and other generalized media	55	4.8

Corporations Included in This Study

American Broadcasting
American Petrofina
American Tobacco
American Standard
Atlantic Richfield
B.F. Goodrich
Burroughs
Caterpillar Tractor
Charter
Control Data
Deere
Digital Equipment
Dow Chemical
Eastman Kodak
Firestone
Fluor
Fruehauf
General Mills
Greyhound
Grumman
Harris
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Phillip Morris
Phillips Petroleum
Ralston Purina
Rohm and Haas
Southland
Standard Oil (Ohio)
Sterling Drug
Swift Independent Packing
Texaco
Tosco
United Brands
Warner Communications
Westinghouse

An additional 12 corporations responded but did not wish to be listed.

groups of employees.

Many respondents indicated that developing effective communications with employees about 401(k) plans posed a continuing challenge to benefits administrators. Several indicated that employees continue to have difficulty understanding that funds cannot be withdrawn except for approved hardships. In one company the introduction of loan provisions came about because of employee complaints; the job of communications then became easier. One respondent indicated that employees signed up because they were told 401(k) plans were beneficial, not because they read excellent available material.

Plan start-up periods posed particular communications challenges. Filmstrips with voice-overs, posters, notices accompanying payroll checks and personal invitation letters were some of the devices used during the initial plan periods. One company reported great success using individual employee statements which illustrated the difference between before-tax and after-tax contributions to the plans.

Three respondents indicated that at least one year should be allowed to properly develop and disseminate information about the plan before it begins to operate. Another stated that the plan's success was due to the fact that it was initiated in stages throughout the organization so that communications efforts could be focused on one group of employees at a time.

In related responses, benefits directors indicated other implementation difficulties with these plans. These included difficulties with outside recordkeepers; problems connected with the coordination of effort among internal groups such as payroll, personnel, and management systems; difficulties handling non-eligible adjustments to salary such as workers' compensation; problems developing employee loan provisions and procedures; and difficulties coordinating information among various company units and subsidiaries.

Despite these difficulties, most respondents indicated that the size of their benefits administration units was adequate to handle the communications workload which these plans generated. Most respondents indicated that the number of central staff persons providing in-

formation about tax-deferred salary reduction plans to their employees ranged between three and five persons. Thirty-three organizations indicated that these staff levels were adequate, while six responded that additional personnel were needed. Most of the positive responses added that the responsibility for disseminating information about these plans was shared with staff persons in other operating units and subsidiaries. Others indicated that additional help was required during plan start-up or modification periods.

The respondents were also asked to indicate how they keep on top of the changes in Federal laws and regulations which affect 401(k) plans. They were asked to rank order their responses with the most useful methods receiving the lowest rankings (#1 for most useful, #2 for next most useful, etc.). Table 7 summarizes these replies.

Conclusion

It is evident from the results of this survey that tax-deferred salary reduction plans are enjoying widespread and growing acceptance among employees of the largest corporations in the United States. Despite communications and administrative difficulties, participation levels and rates are quite high, especially among middle-aged employees. For some employees, the sums being deferred may create significant sources of retirement income. After-tax retirement income from 401(k) plan distributions has the potential to exceed after-tax income from pension plans or Social Security or Individual Retirement Accounts.

Continued study of all sources of retirement income is required. The experiences of smaller and more specialized firms may yield additional information about 401(k) plans which will give more knowledge about how salary reduction arrangements can provide retirement income for individuals. Additional studies can expand and refine the data presented here.

One survey respondent called 401(k) plans "the employee benefit of the decade." Future generations of American employees may find it to be their most significant retirement benefit as well. □

Alan D. Entine has been director of the Mid-Life Assessment Program at the State University of New York at Stony Brook since 1976. This is a multidisciplinary graduate program focusing on middle and old age. Dr. Entine is also a consultant to government and industry.

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Financing Choices Change the Real Estate Investment Picture

Do You Want To Terminate Your Pension Plan?

Fuqua Fights Rising Health Care Costs

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Cover: Fountain Place, twin 60-story silver-glass towers (superimposed) are changing the Dallas skyline. The New York State Teachers' Retirement System provided a $174 million loan commitment for the project. Photo courtesy of Criswell Development Company, Dallas. Our special section on real estate investing begins on page 18.

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How do mutual fund managers make investment decisions?

Textbook techniques have few adherents among investment practitioners, according to this study.

The purpose of this paper is to highlight the results of a questionnaire directed to the managers of 163 mutual fund portfolios. The managers were asked to describe their management techniques and comment on the academic viewpoint of portfolio management. Since the 1970 study by Smith and Goudzwaard[1], limited attention has been given in the investments literature to current portfolio management practices. As a consequence, there is little evidence concerning the techniques of security selection, market timing, and diversification that are being employed by practitioners. There is even less known about how practitioners measure their success at these activities. Conversely, the literature consists of numerous texts and articles written by academicians on the general topic of "modern" portfolio management techniques.

Smith and Goudzwaard discussed in detail the argument concerning whether investment education leads, lags or moves concurrently with industry practice. Although they were unable to reach a definitive answer, their results did suggest that a wide gap exists between the viewpoints of practitioners and academics concerning many portfolio management issues.

This study also identifies a major gap between the academic view of portfolio management and the actual practices of a sample of mutual fund managers. Since the academic viewpoint is well documented in textbooks and journal articles, this paper presents the view of mutual fund portfolio managers, based on their responses to a mail survey. To the authors' knowledge, no research since the Smith and Goudzwaard article has attempted to investigate the current practices and procedures used by portfolio managers.

This article is based on a more extensive study[2] that also relates the questionnaire results to possible implications for the assumptions, methodologies, and conclusions of academic research directed at investment performance research. The larger study is, therefore, of primary interest to the academic community. This paper highlights current management practices and is directed at the practitioner.

Respondents

A random sample of 163 mutual funds was selected and questionnaires mailed in December 1982. After a follow-up questionnaire, a total of 73 usable responses were received (a 44.8 percent response rate). Table 1 gives a profile of the respondents by fund objective, size, and experience of the portfolio manager.

Analysis of the data indicated that the responding funds are similar to the overall population of mutual funds in terms of fund objectives. Funds of varying size responded, the smallest having $2 million of assets and the largest, $1.4 billion. The mean asset size was $138 million. The majority of responding portfolio managers have five or more years' experience as a manager.

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Security selection

The survey questions dealing with security selection (identifying under- and over-valued securities) attempted to determine how the portfolio manager evaluates the success of individual security analysts and the success of the fund in selecting undervalued securities. The vast majority of portfolio managers (32.9 percent) indicated they do not have a formal procedure to evaluate the selection success of their analysts. Even fewer (28.2 percent) said they formally evaluate their fund's selection success separately from overall performance. A few portfolio managers described how selection performance was measured, but generally their responses were not specific enough to be reported in this study.

Market timing

The survey included comprehensive questions about market timing that covered both the techniques employed and how the success of timing efforts is evaluated. Timing was defined for the survey participants as "the shifting of portfolio assets into more market sensitive securities prior to an expected rising market and vice versa." Fifty-nine percent of the respondents indicated they use market timing. The

majority indicated they concentrate their efforts on identifying market trends that will continue for six months or longer. The implication is that timing is an important activity for mutual funds, but primarily for major or long-term market trends rather than for short-term minor cycles.

Table 2 provides some interesting information about the techniques used to implement timing strategies and the importance of each technique. It indicates that the most important timing technique involves shifting cash into or out of bonds and/or stocks. Of the funds that use market timing, 95 percent indicated they use this particular timing technique, and most view it as being a very important activity. Shifting portfolio funds between stocks and bonds and shifting assets within a single class of securities are also used by some portfolio managers; however, these techniques are of less importance.

Questions about the importance of selection and timing to total return performance received interesting responses. Assuming that managers are actively trying to "beat the market," do they attribute their success more to timing activities or selection, or equally to both? The mean percentages indicated in Table 3 clearly indicate that selection of undervalued securities is viewed as the primary source of returns. It is interesting to note, however, that one respondent feels that timing accounts for as much as 80 percent of the total fund return. The responses imply that although both timing and selection are used by fund managers, selection is much more important as a source of return—even with the major market movements of recent years.

Another important activity of a portfolio manager is risk management. While the Investment Company Act specifies certain types of diversification requirements, the survey asked the respondents to indicate other self-imposed requirements. Approximately half the respondents indicated the existence of additional requirements, which are presented in Table 4.

The most common requirement is a limitation on investments in a single industry. Limits are less frequently imposed on the proportion of equity or fixed income investments, or restrictions by geographic region and company characteristics. These results imply that fund managers feel that adequate diversifica-

Table 1 Characteristics of the Mutual Funds Participating in the Survey

	Number of Funds	Percent of Total Respondents
Fund Objective		
Maximum Capital Gains	16	21.9%
Long-Term Growth of Capital, Income Secondary	31	42.5
Growth and Current Income	14	19.2
Income Flexible Policy	10	13.7
Balanced	2	2.7
Totals	73	100.0%
Assets Managed by the Funds		
$15 million and less	20	27.4%
$15.1 million to $50 million	20	27.4
$50.1 million to $150 million	17	23.3
More than $150 million	16	21.9
Totals	73	100.0%
Years the Current Portfolio Manager Has Managed the Fund		
Less than 1 year	8	11.0%
1 to 2.9 years	16	21.9
3 to 4.9 years	9	12.3
5 years or more	40	54.8
Totals	73	100.0%

Table 2 Importance of Various Timing Methods Number of Responses (Percent)

Timing Method	Very Important	Moderately Important	Somewhat Important	Not Important	Totals	Weighted Response*
Shifting cash or near-cash assets into bonds and/or stocks and vice versa	25(62.5)	7(17.5)	6(15.0)	2(5.0)	40(100.0)	3.38
Shifting assets within a risk class (e.g., exchanging stocks with volatile prices for stocks with less volatile prices)	5(13.2)	10(26.3)	18(47.3)	5(13.2)	38(100.0)	2.39
Shifting assets from stock investments to bond investments and vice versa	8(22.2)	2(5.6)	7(19.4)	19(52.8)	36(100.0)	1.96

*Calculated using a value of 4 for "very important," 3 for "moderately important," 2 for "somewhat important," and 1 for "not important."

tion is achieved by complying with legal restrictions and by limiting the amount of exposure to a single industry. The vast majority of fund managers responding to a separate question indicated they do not attempt to measure diversification statistically as suggested such by academic researchers as Francis and Archer.[3] Also, a few fund managers (11 percent) try to measure the success of their diversification efforts.

Performance evaluation

One very popular subject of recent academic research concerns the use of quantitative models and techniques to evaluate portfolio performance. Mathematical portfolio analysis based on capital market theory and suggested by Jensen[4], Sharpe[5], Treynor[6], and others, essentially requires an evaluation of returns relative to the risk of the portfolio. Past academic studies that use these techniques to evaluate mutual fund performance have generally concluded that mutual funds cannot consistently "beat the market."

The vast majority of mutual fund managers responding to questions about performance evaluation indicated that they do not use the academically suggested techniques. Not surprisingly, they reject the conclusion that mutual funds cannot consistently "beat the market." As Table 5 indicates, most fund managers assess performance by making a comparison of their returns with the returns of other funds having similar objectives, or with a market index such as the S&P 500. It should be noted that the former method implicitly considers risk (although perhaps not adequately), while the latter does not.

Another interesting aspect of performance evaluation concerns how funds feel about their own performance. As indicated above, academic studies generally indicate that mutual funds cannot consistently outperform the market. As Table 6 shows, however, approximately 76 percent of the respondents indicate their *overall* performance over the past five years is either good or outstanding. They also rate their performance in the area of selection as good or outstanding. However, they feel they are less successful in conducting their timing and diversification activities. Clearly this Table illustrates the divergence between the views of practitioners and academicians concerning performance.

When one compares the responses to the questionnaire used in this study to the academic viewpoint of portfolio management frequently reported in the literature, there is clearly a major gap between the two viewpoints. One major difference concerns diversification: how can it be achieved, and how

Table 3 Percentage of Total Return Attributable to Timing and Selection

	N	Range High	Range ow	Mean	Std. Deviation
Successful Timing	60	80.0%	0.0%	19.0%	19.8%
Successful Selection	66	100.0%	0.0%	78.5%	24.5%

Table 4 Self-Imposed Mutual Fund Diversification Requirements

Requirement	Number of Responses	Percent of Funds
Limits on the amount of investment in a single industry	33	89.2%
Limits on the proportion of total assets invested in equities or fixed income securities	6	16.2
Geographical restrictions	1	2.7
Limits on the amount of investment in companies with specific characteristics (foreign, young companies, etc.)	2	5.4

Table 5 Methods of Portfolio Performance Evaluation Used by Mutual Fund Managers

	Number	Percent of Mutual Funds*
Compare fund returns with those of funds having similar objectives	67	91.8%
Compare fund returns with a market index such as the S&P 500	65	89.0%
Pay an outside firm to evaluate portfolio performance	9	12.9%

*Participants were not limited to one response.

Table 6 Portfolio Managers' Evaluations of Their Funds' Performance During the Past Five Years Number of Responses (Percent)

	Outstanding	Good	Average	Needs Improvement	Totals*	Weighted Response**
Timing	9(10.2)	19(36.8)	18(36.7)	7(14.3)	49(100.0)	2.45
Selection	23(34.8)	31(47.0)	9(13.6)	3(4.6)	66(100.0)	3.12
Diversification	9(17.0)	24(45.2)	15(28.3)	5(9.4)	53(100.0)	2.70
Overall Performance	23(32.4)	31(43.7)	14(19.7)	3(4.2)	71(100.0)	3.04

*Portfolio managers were permitted to respond "not applicable." These responses do not appear in this table.
**Calculated using a value of 4 for "outstanding," 3 for "good," 2 for "average," and 1 for "needs improvement."

can its success be measured? Another gap that exists concerns the academic community's view of efficient capital markets and the merits of passive investment management, versus the practitioners who favor active strategies involving selection and timing. Practitioners clearly feel they can identify under- and overvalued securities and that these activities make a significant contribution to overall portfolio returns. They are less confident of their timing activities, however, and the contribution of timing to overall portfolio performance.

Views on performance evaluation are also quite different. Measures of performance based on a statistical evaluation of risk as suggested in academic research are largely ignored by portfolio managers. Practitioners continue to feel that performance can best be evaluated by comparing portfolio returns to the returns on portfolios with similar objectives.

The practitioners participating in our study also place little importance on academically derived portfolio management tools. When asked to indicate the importance of seven different academically derived tools, all of the tools were judged to be "not important" by the majority of the portfolio managers. The tools listed included beta and standard deviation as risk measures, Markowitz portfolio analysis, and others. This offers dramatic evidence of the gap between the views of the academic community and the views of practitioners.

This paper is unable to answer the question of *why* there is a gap between theory and practice. Does it exists because practitioners are unwilling to use the ideas offered by academicians because they feel they have limited practical value? Or does the gap exist because the academic community has done a poor job of communicating their ideas to the practitioner? □

FOOTNOTES

1. Keith V. Smith and Maurice B. Goudzwaard, "Survey of Investment Management: Teaching Versus Practice," *The Journal of Finance* (May 1970), pp. 329-347.

2. E. Theodore Veit and John M. Cheney, "Mutual Fund Timing, Selection and Diversification: A Survey," forthcoming in *The Financial Review.*

3. Jack C. Francis and Stephen H. Archer, *Portfolio Analysis,* 2nd Ed., Prentice-Hall, Inc., Englewood Cliffs, NJ, pp. 232-237.

4. M.C. Jensen, "The Performance of Mutual Funds in the Period 1945-64," *The Journal of Finance* (May 1968), pp. 389-416.

5. William F. Sharpe, "Mutual Fund Performance," *Journal of Business* (January 1966), pp. 119-138.

6. Jack L. Treynor, "How to Rate Management of Investment Funds," *Harvard Business Review* (July-August 1966), pp. 131-136.

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